CONFERENCE CHATTER

How small banks can win deals

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By Zach Fox *Market Intelligence*

Small banks can win more deals by evaluating them differently, taking advantage of a recent regulatory change or focusing on non-economic factors, deal advisers said at a recent banking conference.

Privately held banks, which tend to be smaller than public ones, are at a disadvantage when bidding on deals because they lack a publicly traded stock to use as a currency. Many of the most successful serial acquirers enjoy publicly traded stocks that trade at a premium to book value. By contrast, privately held banks often need to rely on cash.

Deal advisers said private banks can be more competitive by pricing deals differently. At Bank Director's Acquire or Be Acquired conference in Phoenix, attendees said privately held banks too often focus on tangible book value earnback, a measure of how long it takes for an acquirer to recoup the book dilution from a deal. The public market has made clear that tangible book value dilution is the most important metric in evaluating deals, as investors have punished bank stocks after deal announcements that feature earnback periods significantly longer than three years.

Investment bankers said publicly traded banks have to focus on earnback in deal-making or their stocks will suffer. However, they said privately held banks have become too concerned with the metric. The banks are following the stock market's demands despite not having to worry about a public market reaction, unless they have imminent plans for a public offering.

"It is a dominant metric in publicly traded bank deals, and private bank deals have adopted it even though it may not be as relevant to them," Curtis Carpenter, principal and head of investment banking for Sheshunoff & Co., said in an interview.

Advisers said private banks should instead focus on earnings accretion or internal rate of return. For example, Carpenter said, it might make sense for a private buyer to wait six years to earn back the dilution if the same deal can boost earnings by 20%.

"The analytics are different for cash than for stock deals," Craig Mancinotti, managing director for ProBank Austin, said in an interview. "The internal rate of return is something that the market has not emphasized that much. It really has been almost a singular focus on tangible book dilution. And that is the metric that normally runs up against a wall first and soon as you hit that wall, people say, 'That's all I can afford to pay.' And I do think that's short-sighted."

Essentially, a private bank could outbid a publicly traded competitor by prioritizing a different valuation metric. Some attendees noted that credit unions have increasingly taken that approach to win deals to buy banks.

For small publicly traded banks, several deal advisers said tangible book value dilution had to remain a priority. But those banks have other options to outbid larger competitors. For example, recently passed regulatory reform legislation included an increase in the asset threshold for a "small bank holding company" to $3 billion from $1 billion. The most significant advantage of the designation is that regulators do not evaluate the holding company's leverage, only the banking subsidiary's. That means the holding company can issue debt and downstream the funds as capital to the subsidiary, which can then use those funds to bid on acquisitions. Rick Childs, advisory services partner for Crowe, called the asset threshold increase a "hidden gem of regulatory reform" that many small banks have not paid enough attention to.

"There are plenty of bankers' banks and other correspondent banks that are happy to lend [to] you at the holding company," he said in an interview.

Advisers also said small banks, both privately held and publicly traded, can win bank deals by focusing on "social issues." The nonmonetary issues can range from offering the target institution's leadership positions on the board or ensuring certain staff members are retained.

"Community banks have the ability and willingness to be flexible with sellers to give them some social aspects that they want. The big companies come in and — I don't want to say it's a bloodbath — but they have their way of doing things," Mancinotti said, defining big companies as having $5 billion of assets and higher. "They tend to be very rigid."

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